

STATEMENT OF RICHARD S. FULD, JR.
BEFORE THE
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
OCTOBER 6, 2008

Chairman Waxman, Ranking Member Davis, and Distinguished Committee Members,

We are in the midst of unprecedented turmoil in our capital markets. The problems that most believed would be contained to the mortgage markets have spread to our credit markets, our banking system, and every area of our financial system. As incredibly painful as this is for all those connected to or affected by Lehman Brothers – this financial tsunami is much bigger than any one firm or industry. Violent market reactions to a number of factors affected all of the financial system. These problems are not limited to Wall Street or even Main Street. This is a crisis for the entire global economy.

No one realized the extent and magnitude of these problems, nor how the deterioration of mortgage-backed assets would infect other types of assets and threaten our entire system. In April 2006, Chairman Bernanke predicted that the housing market “will most likely experience a gradual cooling rather than a sharp slowdown.” In March 2007, he stated “the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained.” Similarly, Secretary Paulson said in June 2007 that the crisis in the mortgage markets “will not affect the economy overall,” echoing the views of the International Monetary Fund. And at Lehman Brothers’ annual shareholder meeting, I too said what I absolutely believed to be

true at the time – that the worst of the impact to the financial markets was behind us.

With the benefit of hindsight, I can now say that I and many others were wrong.

Far from the credit crisis being contained, we now exist in a world where there are no major independent investment banks; where AIG, Fannie Mae and Freddie Mac are under government control; where we are seeing the largest bank seizures in history; and where we are struggling daily to stabilize the financial system. These events have been as stunning as they have been swift. On September 14, there were four major stand-alone investment banks, and they were considered essential for the flow of capital to and investment in American business. Within a week, there were none. Since July of this year, nine banks across the United States have been taken over by government regulators. Creditors and shareholders have lost money on their investments, employees in the financial industry – from support staff, administrative professionals, and recent college graduates to thirty-year veterans – have already lost jobs. Around our country, workers in industries dependent upon the flow of credit fear they could be next.

I will try my best to be helpful to this Committee, so that what happened to Lehman Brothers does not happen to other companies; so that their shareholders, creditors, clients and employees do not have to feel the enormous pain that our shareholders, creditors, clients and employees are feeling right now. I welcome this opportunity to be helpful to this Committee in its important work, and also to address the issues that Lehman Brothers faced. Some of the media coverage of Lehman Brothers' demise has been sensationalized – based on rumors, speculation, misunderstandings and factual errors. I believe to move forward, we first need to accurately understand how we got here.

By way of background, I am a Lehman lifer. I started 42 years ago as an intern while I was in college at the University of Colorado. I moved to New York and started working full time for Lehman Brothers in 1969, and later began taking night classes at New York University to earn my business degree. I have never left Lehman Brothers.

Founded in 1850 in Montgomery, Alabama by three brothers who ran a dry-goods store, Lehman Brothers has played a significant role in the American economy. Lehman Brothers financed the growth of railroads as Americans pushed west, and funded legendary American businesses, from Sears, Roebuck and Woolworth's to B.F. Goodrich and RCA. In 1984, Lehman Brothers was acquired by American Express and merged with Shearson. In 1994, we became independent again, after American Express spun off Lehman Brothers to its shareholders. At the time, our Firm had only 9,000 employees and \$75 million in earnings.

Over the next decade, we restored the once proud Lehman Brothers name. In 1998 we joined the S&P 500 index; by 2000, we had joined the S&P 100 index. In 2002, we executed the largest financial services IPO in history. In 2004, we advised on two of the top five largest worldwide M&A deals. In 2005, we were awarded "Best Investment Bank" by *Euromoney*. In 2006, Barrons ranked us #1 in its annual survey of corporate performance of Fortune 500 firms. In 2007, we were ranked #1 "Most Admired Securities Firm" by *Fortune*. Between 2004 and 2007, we had four consecutive years of record-breaking financial results. Between 1994 and 2007, our market capitalization grew from \$2 billion to \$45 billion. During this period, our share price went from \$5 per share to \$86 per share, an average annual return for shareholders of

24.6%. We grew to more than 28,000 employees, with more than 60 offices in over 28 countries. Through a commitment to excellence and innovation, Lehman Brothers created value for its clients and investors in the United States and throughout the world.

On September 15, 2008, Lehman Brothers Holdings was forced to declare bankruptcy as a result of an extraordinary run on the bank. The Honorable James M. Peck, Bankruptcy Judge for the Southern District of New York, after the first several days of intense hearings in the bankruptcy proceedings, observed: “Lehman Brothers became a victim. In effect, the only true icon to fall in the tsunami that has befallen the credit markets. And it saddens me.”

Again, I say that in the recent months, many of our nation’s financial institutions have disappeared, been acquired or have received massive government assistance to avoid a similar fate. Our economy is suffering, and everyone in America feels the effect of this turmoil. What has happened is an absolute tragedy.

For us, Lehman Brothers was more than a place of employment, it has been a home. Every single day everyone at Lehman Brothers fought for our venerable Firm. Employees were the largest owner of Lehman Brothers, owning around thirty percent of Lehman’s equity. This aligned our interests with the interests of our shareholders – we had a stake in the future of our Firm. The past several months have been extraordinarily challenging and frustrating. For the employees whose steadfast determination, dedication and loyalty epitomized the best of Lehman Brothers and its culture, this has been very painful both personally and financially. I cannot say enough about their dedication, commitment and loyalty. I feel horrible about what happened.

We saw the undeniable spirit of Lehman Brothers after the tragic events of September 11, 2001. Lehman employees watched the towers fall around them that morning as they fled for safety. We lost a co-worker that day, and we lost our homes at One World Trade Center and Three World Financial Center. In the hours and days that followed, we were dispersed to makeshift offices in and around New York City. We worked around the clock under incredible stress, with the goal of serving our clients and shareholders in a suddenly uncertain world and returning stability to rattled markets. Over that weekend, we built two complete trading floors in our temporary office in Jersey City. When the markets reopened the morning of September 17, to the surprise of many, Lehman Brothers was there.

We still saw this courageous spirit of Lehman Brothers' employees in these last several weeks. Many employees worked 20 hour days, even after we entered bankruptcy, uncertain of whether another paycheck was coming, but wanting to do everything humanly possible to help their clients and their coworkers salvage what they could.

We believed that we were well-protected to withstand even the most difficult markets. What we have seen recently in the international credit markets has overwhelmed many financial institutions and threatened all financial institutions. We did everything we could to protect the Firm, including: closing down our mortgage origination business; reducing our leveraged loan exposure; reducing our total assets by \$188 billion, specifically reducing residential mortgage and commercial real-estate assets by 38%; and dramatically reducing our net leverage so by the end of the third quarter in 2008 it was 10.5 times, one of the best leverage ratios on Wall Street at the time. We

raised capital. We made changes to our senior management team and reduced expenses. We sought strategic investors for a sale of all or part of the Firm. We called on regulators to clamp down on abusive short selling practices.

Throughout 2008, the SEC and Fed actively conducted regular, and at times, daily oversight of both our business and balance sheet. Representatives from the SEC and the Fed were in our offices on a regular basis, monitoring our daily activities. They saw what we saw in real time as they reviewed our liquidity, funding, capital, risk management and mark-to-market process. Lehman Brothers had specific, dedicated teams that worked with the SEC and the Fed to take them through our finances and risk management, and answer any and all of their questions and provide them with all the information they requested. These were open conversations with seasoned and dedicated government officials.

Quarter to quarter, month to month, regulators saw how we reduced our commercial real-estate holdings; how we increased our liquidity pool; how we decreased leverage and strengthened our capital levels. They actively reviewed our risk management reports, which included our hedges for each business. They saw our “mark to market” process and how we arrived at our valuations, including our mortgage and commercial real-estate valuations. They held regular price verification reviews. They were privy to everything as it was happening.

Over the summer, we discussed with the Federal Reserve the possibility of converting Lehman Brothers to a bank holding company, and applied for a regulatory exemption that would permit our Utah bank to receive assets from its affiliates, all for the purpose of creating additional liquidity. On the same day Lehman Brothers prepared to

file for bankruptcy, the Federal Reserve significantly broadened the types of collateral all banks were able to pledge to the Federal Reserve to create additional liquidity, the lifeblood of our system, and the Federal Reserve also adopted, on a temporary basis, the type of exemption that Lehman Brothers had applied for earlier. Had these changes been made sooner, they would have been extraordinarily helpful to Lehman Brothers. A few days later, the Federal Reserve took expedited action to approve applications of Goldman Sachs and Morgan Stanley to become bank holding companies.

After the second quarter, Lehman Brothers developed a series of options to strengthen the Firm, including working with regulators to develop a plan to separate the vast majority of our commercial real estate assets from our core business by spinning off those assets to our shareholders in an independent, publicly-traded entity. We believed this plan would have improved our balance sheet while preserving shareholder value. The spinoff entity would have been able to manage the assets for economic value maximization over a longer time horizon. However, a sharp drop in our share price following leaks to the press about confidential negotiations with Korea Development Bank about a possible investment in Lehman Brothers, and rumors regarding our liquidity and capital, compelled us to pre-announce earnings before we had a chance to complete those plans or any of the alternatives we were pursuing. We then faced the threat of credit downgrades. Counterparties to the numerous transactions we conducted every day started to withdraw business and to demand increased collateral for trades. We had pursued buyers and merger partners to no avail. But by the end of that Sunday, it was obvious that the Federal Reserve had made a decision it would not provide support

for a transaction involving Lehman Brothers. Had that decision been different, further dislocations in the markets might have been avoided.

In the end, despite all our efforts, we were overwhelmed, others were overwhelmed, and still other institutions would have been overwhelmed had the government not stepped in to save them. What happened to Lehman Brothers could have happened to any firm on Wall Street, and almost did happen to others. A litany of destabilizing factors: rumors, widening credit default swap spreads, naked short attacks, credit agency downgrades, a loss of confidence by clients and counterparties, and strategic buyers sitting on the sidelines waiting for an assisted deal were not only part of Lehman's story, but an all too familiar tale for many financial institutions. The fallout from these repeated onslaughts is what has caused the government to intervene to dramatically change the rules and provide substantial support to other institutions.

Now is not the time or place for a detailed analysis of everything that has happened to the international economy in the last year. I do not have the perspective or the information necessary to analyze all of the causes and to propose cures for these problems. Nor do I think anyone can do that yet in a comprehensive fashion. However, I want to address some of the factors that led to this, and what we can do moving forward.

First, ultimately what happened to Lehman Brothers was caused by a lack of confidence. This was not a lack of confidence in just Lehman Brothers, but part of what has been called a storm of fear enveloping the entire investment banking field and our financial institutions generally. As evidenced by Congress' efforts to pass an emergency rescue plan, there is a systemic lack of confidence in the system that without emergency intervention could result in an across the board failure.

While all investment banks were prepared for shocks in the market, none of us was prepared for this one. And all of us are now forever changed. Investment banks depend on the confidence and trust of employees, clients, investors and counterparties. Investment banks, unlike commercial banks, are subject to mark-to-market accounting. The result was we all had to mark our positions to the weakest competitors' fire-sale prices of assets. The commercial banks did not. This put investment banks at a disadvantage. Chairman Bernanke himself recognized there is "good value" over the long-term for these assets being sold at fire-sale prices. These write-downs have been a large contributor to shaking general confidence in investment banks and the banking system. Importantly, the SEC is now addressing this issue.

Lehman Brothers was a casualty of the crisis of confidence that took down one investment bank after another. Bear Stearns collapsed. Merrill Lynch was forced to sell itself to Bank of America. Goldman Sachs and Morgan Stanley received expedited approval to convert themselves to bank holding companies, providing substantial comfort to investors and facilitating their receipt of substantial capital infusions. Again, there are no major stand-alone investment banks left.

The second issue I want to discuss is naked short selling, which I believe contributed to both the collapse of Bear Stearns and Lehman Brothers. Short selling by itself can be employed as a legitimate hedge against risk. Naked short selling, on the other hand, is an invitation to market manipulation. Naked short selling is the practice of selling shares short without first borrowing or arranging to borrow those shares in time to make delivery to the buyer within the settlement period – in essence, selling something you do not own and might not ultimately deliver to the buyer.

Naked short selling, followed by false rumors, dealt a critical, if not fatal blow to Bear Stearns. Many knowledgeable participants in our financial markets are convinced that naked short sellers spread rumors and false information regarding the liquidity of Bear Stearns, and simultaneously pulled business or encouraged others to pull business from Bear Stearns, creating an atmosphere of fear which then led to a self-fulfilling prophecy of a run on the bank. The naked shorts and rumor mongers succeeded in bringing down Bear Stearns. And I believe that unsubstantiated rumors in the marketplace caused significant harm to Lehman Brothers. In our case, false rumors were so rampant for so long that major institutions issued public statements denying the rumors.

Following the Bear Stearns run on the bank, we and many others called on regulators to immediately clamp down on naked short selling. The SEC issued a temporary order that went into effect on July 21 prohibiting “naked” short selling of certain financial firms, including Lehman, Merrill Lynch, Fannie Mae and Freddie Mac. This measure stabilized the share prices of Lehman Brothers and the other firms. However, this restriction was temporary, and on August 13 it expired after 17 trading days. History has already shown how wrong and ill-advised it is to allow naked short selling.

Many of the firms that have recently collapsed or have been forced into emergency mergers, takeovers, or government bailouts – Bear Stearns, Lehman Brothers, Merrill Lynch, Fannie Mae, Freddie Mac, AIG – did so during the gaps of time in which there was no meaningful regulation of naked short selling. On September 15, when the market opened after the collapse of Lehman, naked shorts appeared to turn their attention

to Morgan Stanley and Goldman Sachs. In the three days between the announcement of Lehman Brothers' bankruptcy and the SEC instituting an emergency ban on short selling, Goldman Sachs' and Morgan Stanley's share prices fell 30% and 39% respectively. None of this was a coincidence.

After seeing this stock price reaction in the week following Lehman Brothers' bankruptcy, the SEC, like the Federal Reserve, took immediate action to stabilize the system. On September 18, following the decision of the Financial Services Authority in the United Kingdom a day earlier, the SEC instituted an emergency ban and other restrictions on short selling financial institutions. In taking these steps, Chairman Cox explained: "Given the importance of confidence in our financial markets as a whole, we have become concerned about the sudden and unexplained declines in the prices of securities. Such price declines can give rise to questions about the underlying financial condition of an issuer, which in turn can create a crisis of confidence without a fundamental underlying basis. The crisis of confidence can impair the liquidity and ultimate viability of an issuer, with potentially broad market consequences." These new restrictions are set to expire no later than October 17. Permanent regulation of naked short selling is needed to prevent a similar demise for the firms that survived with the government's help.

The final issue I will address is the changed landscape of our financial system and regulatory regime. Many have recently commented that what we have seen with this market is a once-in-a-century event. We should remember that even eighty years after the fact, academics, economists and politicians still debate the causes and cures of the Great Depression. We exist in a regulatory regime created in a vastly

different world for vastly different markets. Some have compared the regulatory and risk management systems of our current markets to trying to run a bullet train on ancient track. In 1929, the New York Stock Exchange traded about ten million shares a day. Today, that figure is over five billion shares a day – more shares traded every day than were traded in an entire year when the still current regulations were created and put in place. New types of firms, new types of instruments, electronic trading, and a truly global financial marketplace were not anticipated when these early efforts at regulation were enacted into law.

We now have the opportunity to create a new regulatory system and “best practices” for a functioning and orderly market. These new approaches must encourage rather than impede global investment in our capital markets. Shifting and inconsistent rules create a capital markets system that does not give confidence to investors or participants. We need a single set of transparent rules for all of the participants in order to have a fair and orderly market. We must stick to these rules and enforce them evenly, not selectively, or our great capital markets will not be attractive to investors. A loss of investment in our markets would have far-reaching consequences for this country and the American people.

The various proposals being debated came too late to benefit our Firm, but our system today needs liquidity. The inability of businesses and individuals to have access to credit – credit that builds new plants, creates new jobs, pays for college and graduate school for our children, finances the basic needs of families – is not a crisis only for Wall Street. It is a crisis for everyone.

I thank you for allowing me to speak on these issues, and I am available to answer any questions you may have.